For Real? Is Counterfeiting Becoming The ‘New’ Trade Disparagement For Purposes Of ‘Personal And Advertising Injury’ Coverage?

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I. The Problems Of Counterfeiting Of Brand Name Merchandise

Intellectual property litigation is expensive. Litigating an intellectual property claim can involve significant damages and significant defense costs. Although some insurers offer intellectual property insurance, which is specifically drafted and underwritten to provide coverage for copyright and trademark claims, often an insured does not have such coverage. Instead, the insured looks for defense and liability coverage under the “personal and advertising injury” coverage part (Coverage Part B) of a commercial general liability (“CGL”) policy. Although this coverage is narrow and well-defined, it takes only a few court decisions potentially to expand the coverage to risks never contemplated in the policy’s underwriting. Merchandise counterfeiting may be one of those risks.

Counterfeiting has been described by a leading treatise as “the act of producing or selling a product with a sham trademark that is an intentional and calculated reproduction of the genuine mark.” Stated another way, counterfeiting is the passing off of imitation products as authentic, brand name merchandise. Sometimes, counterfeit items are poorly made or of low quality, but not always.

In the “gray market,” for instance, counterfeit items of brand name products manufactured overseas can be constructed using the same materials as the genuine merchandise, and sometimes even at the very same facilities. Thus, counterfeit products can be so-well made to imitate the well-known, genuine product in all details of construction and appearance that consumers are fooled into thinking that they are purchasing genuine, authorized merchandise. Alternatively, consumers may knowingly purchase counterfeit items, such as Uggs®, The North Face®, or Ralph Lauren®, just to name a few, because the counterfeits can be had at prices that are dramatically lower than the genuine products.

The primary difference between the counterfeit item and the genuine product is that the counterfeit item was manufactured “off hours” and is never accounted for on the intellectual property holder’s inventory, thus
allowing third-party smugglers to export them to western markets, to sell at vastly discounted prices on the black and gray markets.²

Quantifying the exact impact of counterfeiting is difficult to do, but its impact is believed to be significant.³ When counterfeited items are trafficked and sold, makers of genuine merchandise lose sales and brand value, and the industry itself can suffer a disincentive to innovate.⁴ There is some evidence that organized criminal and terrorist organizations are involved in counterfeiting; although, the extent of such involvement is difficult to quantify.⁵ In any event, there is little debate that intellectual property holders universally view merchandise counterfeiting as theft.

When counterfeited items are trafficked and sold, intellectual property holders claim to lose sales, brand value, and goodwill. In counterfeiting cases, intellectual property holders routinely claim damage from trademark dilution and loss of goodwill. The damage materializes in one of two ways, or both: (1) when a customer has unknowingly purchased a counterfeit product of inferior quality, the customer will blame the intellectual property holder for the counterfeit’s ultimate failure and decide not to purchase other products from the intellectual property holder, or (2) third-parties, upon seeing the “shoddy” counterfeit, will blame the counterfeiter’s failure on the genuine product and decide not to purchase merchandise from the intellectual property holder. In both instances, an intellectual property holder will claim that its reputation as a manufacturer and the reputation of the quality of its goods have been injured.

Yet, can the sale of counterfeit items—especially when recovery is sought under federal and common law trademark law—implicate coverage under a CGL policy? There is no mention, let alone a reference, to counterfeiting in CGL policies. Insurers argue that CGL policies were never intended to cover allegations of counterfeiting, a fact inherent in the policy language itself. Despite this fact, in this past year, two courts in California found coverage for such claims. In Michael Taylor Designs, Inc. v. Travelers Prop. Cas. Co. of Amer., 761 F. Supp. 2d 904 (N.D. Cal. 2011) and Miranda v. California Capital Ins. Co., 2011 Cal. App. Unpub. LEXIS 2419 (Cal. App. Ct. Mar. 29, 2011), each court held that allegations involving an insured’s passing off of inferior products as the products of another—the very heart of counterfeiting—implicated a duty to defend under a CGL policy (and possibly, a duty to indemnify) based on an implicit, if not unstated, claim for disparagement.

Insurers will view these conclusions as remarkable. How does a disparagement claim based on counterfeiting square with the old adage that imitation is the sincerest form of flattery? After all, an individual or organization producing counterfeit Nike sneakers is not trying to defame Nike or its products. A counterfeiter does not advertise its product as being better, or the genuine merchandise as being worse. To the contrary, a counterfeiter attempts to exploit the goodwill and reputation of well-known brand name items, and tries to pass off its merchandise as the genuine merchandise. Yet, the courts in Miranda and Michael Taylor Designs bridged this disconnect. In doing so, they potentially may have circumvented valid coverage defenses, and their reasoning, if adopted, transformed counterfeiting into a covered claim under a CGL policy.

The decisions may be isolated cases only—although Michael Taylor Designs currently is pending on appeal before the Ninth Circuit. As a result, the Ninth Circuit may have its say on the issue. Considering that California is an epicenter of intellectual property litigation, these decisions very well could be a foreshadowing of more decisions to come, and they may foretell coverage for a risk that insurers never intended to carry.

II. Personal And Advertising Injury Under A CGL Policy And How It Works

CGL policies have two primary coverage parts. Subject to the policy’s terms and conditions, Coverage Part A provides coverage for those sums an insured becomes legally obligated to pay as damages because of “bodily injury” or “property damage” to which the insurance applies.⁶ The terms “bodily injury” and “property damage” are defined in the policy.⁷ Coverage B, subject to the policy’s terms and conditions, provides coverage for those sums an insured becomes legally obligated to pay as damages because of “personal and advertising injury.”⁸

Compared with Coverage Part A, “personal and advertising injury” coverage is narrower, as it focuses on explicit offenses and specified risks. The term “personal and advertising injury” is defined as injury, including
consequential bodily injury, arising out of one or more of a series of enumerated offenses, including the following:

d. Oral or written publication, in any manner, of material that slanders or libel’s a person or organization or dis
parages a person’s or organization’s goods, products or services;

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f. The use of another’s advertising idea in your advertisement; or

g. Infringing upon another’s copy-
right, trade dress or slogan in your “advertisement.”

If allegations of an insured’s wrongdoing do not allege liability under one of the covered offenses listed under the definition for “personal and advertising injury,” the requirements of the definition are not met, and there is no coverage. Commentators recently noted that courts, in general, “have taken a relatively strict view of personal and advertising injury coverage, reading the enumerated items strictly and construing other actions according to their similarity or ‘fit’ with the covered torts.”

III. Trade Libel, Injurious Falsehood, And Liability By Implied Inferiority

According to the Restatement (Second) of Torts, trade libel is the disparagement of the quality of goods and is a form of injurious falsehood. It has been defined by federal courts as "an intentional disparagement of the quality of property, which results in pecuniary damage." A claim for trade libel and disparagement has a potentially broad scope because the individual accused of uttering a defamatory statement is liable not just for what was said, but also for what may be implied or insinuated in the statement. E.piphany, Inc. v. St. Paul Fire & Marine Ins. Co., 590 F. Supp. 2d 1244, 1251 (N.D. Cal. 2008), highlights the potentially broad effect of this standard.

In that case, the insured, E.piphany, was accused of falsely advertising its product software as being “all Java” and “fully J2EE” compliant. E.piphany also claimed it was the first software vendor to “market a complete product suite built on J2EE,” all of which were important differentiators in the product’s market. One of E.piphany’s competitors, Sigma Dynamics, sued E.piphany for false advertising; in essence, Sigma Dynamics alleged that the false statements made by E.piphany save E.piphany an unfair advantage over competitors, some of which did offer “all
Java” and “fully J2EE” software products. Notably, E.piphany’s advertisements never mentioned Sigma Dynamics or its products.

After E.piphany’s insurer, St. Paul, disclaimed coverage, E.piphany commenced a coverage action in California. Following cross-motions for summary judgment, the court held that St. Paul had a duty to defend. The Court reasoned that by claiming the superiority of its own product, E.piphany implicitly disparaged the products of all its competitors, including the products of Sigma Dynamics. The fact that Sigma Dynamics and its products were not mentioned in the advertisements made no difference.

The gravamen of the Underlying Complaint, therefore, is that Plaintiff made false claims about the superiority of its own products, which clearly and necessarily implied the inferiority of Sigma’s competing products, resulting in damages to Sigma. The Court finds that the statements alleged in Underlying Complaint had the potential to give rise to disparagement liability if ultimately proven to be “injurious falsehoods that interfere[d] with [Sigma’s] business.”

As explained below, implicating defense coverage under a liability policy based upon the insinuations of a statement, rather than the statement itself, serves as a basis of the courts’ holdings in Miranda and Michael Taylor Designs.

IV. Inferior Cows And The New Doctrine Of Implied Inferiority
In Miranda, the insureds, who operated a dairy farm, took possession of certain cows owned by the underlying plaintiff, Raymond Christie, with the agreement that the insureds would feed and maintain the cows at their expense; in exchange, the insureds could enjoy any profits realized from the milk that the cows produced. The insureds also were given the first right to purchase the cows, should Christie choose to sell them. When Christie subsequently chose to sell some of his cows, the insureds declined to exercise their right of first refusal, and the cows were sold to a third-party. However, at the time of delivery, the insureds did not deliver Christie’s cows to the purchaser. Instead, they “substituted their own substandard cows, i.e., cull and/or low producing dairy cows, for Christie’s cows,” and misrepresented to the purchaser “that the cows were the property of” Christie and were from Christie’s herd when they were not.

Christie commenced an action, alleging that the insureds had intentionally transferred their inferior cows to the third-party purchaser and misrepresented to both the purchaser and to Christie that the cows had come from Christie’s herd in order to disrupt Christie’s relationship with ranchers and potential buyers. Christie alleged damages from lost profits caused by a loss of his business reputation, and sought recovery under causes of action for breach of contract, intentional and negligent misrepresentation, intentional and negligent interference with business advantage, and conversion. The insureds sought coverage under their CGL policy, and coverage litigation ensued. The court held that the insurer, California Capital Insurance, had a duty to defend.

California Capital Insurance argued that it did not have a duty to defend because the underlying action alleged “nothing more” than “palming off” an inferior product for another product. Although such a claim could constitute unfair competition, it did not constitute trade libel. The court noted that the argument had some merit, but distinguished the case from traditional “palming off” cases, reasoning that the complaint had not only alleged that the insureds presented inferior cows as the plaintiff’s cows, but that the insureds did so “with the intention of disrupting Christie’s business relationships with ranchers.” In other words, the court determined that the case before it was “different from the usual ‘palming off’ case,” because underlying complaint suggested that “the insureds’ intention was not simply to palm off their inferior cows for Christie’s cows (hoping the substitution would go undetected) but also to disrupt Christie’s livestock business by creating the false impression that Christie’s cows are substandard and thereby impairing future sales.”

Importantly, however, the court also reasoned that coverage was implicated because, by passing off their inferior cows as the plaintiff’s, the insured’s implicitly disparaged the plaintiff and his chattel:

Although the insureds did not say Christie’s cows were substandard, they allegedly did say that certain substandard
cows were Christie’s and made the statement to damage Christie’s livestock business. The implication of the insured’s statement was that Christie’s cows were substandard. This fits the broad definition of an injurious falsehood.30

The court reasoned that although the insured’s representation that their inferior cows were Christie’s cows “did not, standing alone, disparage the quality of the cows,” the representation “was understood to cast doubt upon the quality of Christie’s cows, and the insureds intended the statement to cast doubt,” thereby meeting the definition for trade libel.31

Thus, the court appears to have taken the disparagement of “implied inferiority” reasoned in E.piphany and other courts, and concluded that the act of passing off an inferior product as a genuine product implicitly represents that the genuine product is inferior and disparages it. Thus, on the basis of an implied inferiority, the court believed the allegations implicated the insurer’s duty to defend:

The implication of the insureds’ alleged statement (these are Christie’s cows) was not facially defamatory but was potentially defamatory, sufficient to trigger a duty to defend, in the context of the insured’s other statements and conduct. One accused of libel is responsible “for what is insinuated, as well as for what is stated explicitly.”32

V. The Sale Of “Cheap Synthetic Knockoff’s”

Michael Taylor Designs33 takes the line of insurance coverage for an insured accused of trafficking counterfeit merchandise one step closer.

In that case, the insured, Michael Taylor Designs, Inc. (“MTD”), was a furniture retailer sued for allegedly infringing the trade dress of one of its former suppliers by offering “cheap synthetic knockoffs” of that supplier’s high-end wicker furniture products. The underlying complaint alleged that MTD had a business relationship with furniture designer Ivy Rosequist in which MTD acted as the exclusive sales agent for Rosequist’s high-end line of wicker furniture.34 The relationship soured, however, when MTD began selling synthetic wicker products that Rosequist contended were unlawful copies of her designs.35

Rosequist thereafter filed a two count complaint against MTD, alleging breach of contract and violation of the Lanham Act.36 Rosequist’s Lanham Act claim alleged that MTD had distributed promotional materials to its customers that contained photographs of Rosequist’s distinctive and high-quality furniture, but that MTD then pulled a “bait-and-switch” by selling in its showroom “cheap synthetic knock-offs” of Rosequist’s merchandise; Rosequist contended that consumers would be confused and misled as to the origin of the knock-off items, thinking that the products were her own.37 Rosequist claimed MTD’s actions would “dilute and tarnish” her trade dress.38 The complaint later was amended to include a claim for relief entitled “Slander of Goods/Slander of Title,” which repeatedly alleged that MTD had “disparaged the quality and origin” of Rosequist’s goods.39

MTD sought coverage under its CGL policy, issued by Travelers Property & Casualty Company of America. The Travelers policy at issue contained a “Web Xtend Liability” endorsement, which deleted that part of the definition for “personal and advertising injury” that would have provided coverage for trade dress infringement, and instead provided coverage only for “[o]ral, written or electronic publication of material that slanders or libels a person or organization or disparages a person’s or organization’s goods, products or services.”40 The primary question presented to the court, therefore, was not whether trade dress infringement was alleged, but instead whether “the factual allegations of the original complaint filed against MTD were sufficient to give rise to a duty defend, despite the claims having been couched in language of trade dress infringement rather than in terms of disparagement.”41

Because the complaint alleged that the counterfeit merchandise would harm the reputations of both Rosequist and her products, the court held that the factual allegations sufficiently implicated the duty to defend.

Specifically, the complaint alleged that:

- “The promotional materials widely circulated by Michael Taylor Designs, Inc. for the patrons of Westweek
includes photographs of [Rosequist’s] actual furniture (which Michael Taylor Designs, Inc. has removed from its showroom and is no longer selling), compounding the high risk that customers will visit Michael Taylor Designs, Inc. looking for [Rosequist’s] furniture, only to be unknowingly steered instead to cheap imitation knock-offs.”

- “Consumers are likely to be confused and will naturally assume that the knock-offs currently being displayed in Michael Taylor Design’s showrooms are plaintiff’s products.”

- “Defendant’s action, unless enjoined, will cause irreparable harm and injury to plaintiff and to consumers, in that it will substantially dilute and tarnish plaintiff’s established trade dress and mislead consumers about the true origins and nature of the cheap synthetic knockoffs.”

The court concluded that these allegations were sufficient to allege disparagement, explaining that “the very essence of the injury [Rosequist was] alleging was damage to the reputation of Rosequist’s products that would result from consumers encountering ‘cheap synthetic knock-offs’ and believing them to be products manufactured and marketed by Rosequist.” Unlike in Miranda, supra, there was no allegation that MTD purposefully sought to harm Rosequist’s reputation. The issue was whether a disparagement claim could be read into an action based on the sale of “cheap synthetic knock-offs.” The court concluded that a claim could be so-read, even noting that “[u]ndoubtedly, at the time Rosequist’s complaint was originally filed, her lawyers did not have a claim for disparagement or trade libel at the forefront of their legal theories.”

In so holding, the court rejected a common argument that the sale of knock-off merchandise cannot constitute disparagement because imitation is a form of flattery, not disparagement. Given Rosequist’s claim for loss of reputation, the court held that in situations of trafficking counterfeit merchandise, there was no authority that “advertising an inferior item as if it were the product of another invariably falls outside disparagement.” That the claim was couched as a trade dress violation—and not a disparagement claim—also mattered little: “[b]ecause Rosequist was expressly alleging that the reputation of her goods was harmed by MTD’s conduct, the mere fact that it was labeled as trade dress infringement does not preclude the possibility of a disparagement claim.” The “very essence” of the injury alleged “was damage to the reputation of Rosequist’s products that would result from consumers encountering ‘cheap synthetic knock-offs’ and believing them to be products manufactured and marketed by Rosequist.”

VI. Making Sense Of It All: Where To Go From Here?

It is too early to tell whether Miranda and Michael Taylor Designs, and the line of reasoning reflected in those cases, will gather momentum. As noted earlier, Michael Taylor Designs is on appeal before the Ninth Circuit. The outcome of that appeal undoubtedly could have a dramatic effect on the landscape of coverage.

If the Ninth Circuit upholds the district court’s decision, or if other courts in other jurisdictions accept the reasoning expressed in Michael Taylor Designs and Miranda, will the face of trademark enforcement change? Will a claim for dilution of a trademark begin to transform into a form of trade libel? Will there be an uptick in litigation over counterfeiting? Intellectual property litigation can be costly. Because many counterfeiting cases involve small players with little or no assets, or foreign-based defendants who are difficult to reach, these cases have significant collection problems for successful plaintiff intellectual property holders. For this reason, many intellectual property holders often may not pursue litigation as a means of recourse. As any plaintiff’s lawyer will tell you, however, the world changes upon the emergence of a deep pocket. For plaintiffs, insurance is the most coveted of all deep pockets. We could see a radical change in the frequency and strategy of counterfeiting litigation if intellectual property holders become more willing to initiate such litigation with the knowledge that insurance policies exists from which they can collect. On the flip side, if counterfeiters are entitled to defense coverage, there may be a dramatic decrease in default judgments against suspected counterfeiters, and a greater longevity and complexity of such litigation.
Certainly, as 2012 unfolds, it is worth watching closely whether the line of reasoning expressed in *Miranda* and *Michael Taylor Designs* spreads. A whole new risk could find itself within CGL coverage. Underwriters and ISO drafters may wish to monitor the situation, and take note.

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**Endnotes**

1. 4 *McCarthy on Trademarks and Unfair Competition* § 25:10 (4th ed.).

2. One treatise recently remarked that counterfeiting in gray markets is as much as inventory-control problem than anything else. Sugden, David R., *Gray Markets* 3, 9-25 (Oxford Univ. Press 2009).


6. *E.g., CGL Coverage Form, Section I.1.a., Coverage A* (ISO Form CG 00 01 12 07) (hereinafter, “CGL Policy”). All citations in this article to CGL policy provisions refer to provisions found in the ISO Form CG 00 01 12 07.

7. *Id., Section V.3. and 17.*

8. CGL Policy, Section I.1.a., Coverage B.

9. CGL Policy, Section V.14. Other offenses listed under the definition for “personal and advertising injury” include false arrest, detention or imprisonment; wrongful eviction from, wrongful entry into, or invasion of the right of private occupancy of a room, dwelling or premises that a person occupies, committed by or on behalf of its owner, landlord or lessor; and oral or written publication, in any manner, of material that violates a person’s right to privacy.


12. Although, some courts have held that a trademark constitutes a form of “advertising idea.” *See, e.g., Kim Seng Co. v. Great American Ins. Co.*, 101 Cal. Rptr. 3d 537, 543 (Cal. Ct. App. 2009). The policy exclusion for trademark infringement, discussed below, since has limited the affect of these decisions.

13. CGL Policy, Section I.2.i, Coverage B. The exclusion does not apply to “infringement, in your ‘advertisement’, of copyright, trade dress or slogan,” thus preserving the narrow scope of coverage provided for in the corresponding offense listed in the definition for “personal and advertising injury.” The exclusion also has undergone some changes since first being introduced into the main CGL policy form. Notably, in ISO Form CG 00 01 12 07, the following language was added to the exclusion: “Under this exclusion, such other intellectual property rights do not include the use of another’s advertising idea in your ‘advertisement’.”


15. *Microtec Research, Inc. v. Nationwide Mut. Ins. Co.*, 40 F.3d 968, 972 (9th Cir. 1995); *see also Travelers Prop. Cas. Co. of Amer. v. Hillerich & Bradshy Co.*, 598 F.3d 257, 269 (6th Cir. 2010); *Bacchus Indus., Inc. v. Arvin Indus., Inc.*, 939 F.2d 886, 892 (10th Cir. 1991). *Restatement (Second) of Torts*, § 623A. Under California law, trade libel is viewed as more akin to unfair competition and is not actionable as defamation. *Microtec*, 40 F.3d at 972.


17. *Id.*

18. *Id.* at 1250.

19. *Id.* at 1253.
20. *Id.* at 1253 (emphasis added); accord *Burgett, Inc. v. American Zurich Ins. Co.*, – F. Supp. 2d –, 2011 WL 5884251, at *7 (E.D. Cal. Nov. 23, 2011) (holding claim by insured that it was the “only” holder of trademark disparaged underlying plaintiff, who also used trademark, by implying that plaintiff had no right to use it, thereby implicating duty to defend under “personal and advertising injury” coverage).


22. *Id.* at *3.

23. *Id.*

24. *Id.* at *3-4.

25. *Id.* at *4.

26. *Id.*

27. *Id.* at *11-12. Generally, “palming off” is the act of passing off another’s product as one’s own.

28. *Id.* at *12.

29. *Id.*

30. *Id.* at *13 (emphasis added).

31. *Id.* (quoting Restatement 2d of Torts § 629).

32. *Id.* at *16.

33. 761 F. Supp. 2d 904 (N.D. Cal. 2011).

34. 761 F. Supp. 2d at 907.

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.* at 908.

40. *Id.* at 907, 910-11.

41. *Id.* at 907.

42. *Id.* at 910-11 (emphasis in original).

43. *Id.* at 911.

44. *Id.* at 911.

45. *Id.* at 911.

46. *Id.* at 912.

47. *Id.* at 911.

48. Perversely, would the availability of insurance coverage actually encourage the trafficking of counterfeit merchandise? Certainly, the availability of coverage could lower the perceived costs of engaging in such illicit business. ■